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Report to the Honorable
Jesse Helms, U.S. Senate

November 1988

FARMERS HOME ADMINISTRATION

Farm Loan Programs Have Become a Continuous Source of Subsidized Credit

GAO/RCED-89-3

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Resources, Community, and
Economic Development Division

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November 22, 1988

The Honorable Jesse Helms
United States Senate

Dear Senator Helms:

As you requested, we examined the Farmers Home Administration (FmHA) process for graduating farm program borrowers to other sources of credit and estimated the amount of government interest rate subsidy received by FmHA borrowers. This report provides several recommendations to the Secretary of Agriculture for improving FmHA's management of the graduation process. It also raises fundamental questions regarding FmHA's mandate to be a temporary source of credit while, at the same time, fulfilling its role as a lender of last resort.

As arranged with your office, we are sending copies of this report to appropriate House and Senate Committees; interested members of Congress; the Secretary of Agriculture; and the Director, Office of Management and Budget. Copies will also be made available to other interested parties who request them.

This work was performed under the direction of John Harman, Associate Director. Other major contributors are listed in appendix IV.

Sincerely yours,

J. Dexter Peach

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

The Farmers Home Administration (FmHA) faces a dilemma in finding the appropriate balance between acting as the lender of last resort for family farmers who cannot get credit elsewhere while at the same time fulfilling its congressional mandate to serve as a temporary source of credit. FmHA borrowers are to graduate to other sources of credit as soon as they are able to do so. The Congress, however, has also directed FmHA to keep family farmers in business, when possible, through the extension of additional credit and the restructuring of existing debt.

Senator Helms, Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry at the time of his request, asked GAO to determine

- if FmHA is graduating borrowers as intended,
- whether FmHA has evolved into a long-term source of credit, and
- the amount of government interest rate subsidy and financial advantage received by FmHA borrowers.

Background

The Consolidated Farm and Rural Development Act of 1961, as amended, established FmHA as a temporary source of credit for farmers whose financial situations prevent them from obtaining credit elsewhere at affordable rates and terms. FmHA is commonly referred to as the lender of last resort. It makes loans available to farmers primarily to finance farm ownership, operating expenses, natural disaster losses, and soil and water resource improvements.

FmHA borrowers are to graduate to non-FmHA sources of credit upon a determination by the Secretary of Agriculture that they can obtain credit elsewhere at reasonable terms. FmHA regulations define graduation as "the payment in full of an FmHA loan before maturity by refinancing through other credit sources." Further, the regulations prescribe a step-by-step annual process for ensuring that borrowers capable of obtaining non-FmHA financing are identified and graduated.

The Congress also has directed FmHA to give the highest priority to the preservation of its borrowers and their farming operations. Various laws have directed FmHA to extend credit to farmers who have limited loan repayment ability and to restructure uncollectible debt if it is financially more advantageous to the government than foreclosure and liquidation of the borrower's assets.

Results in Brief

Few FmHA borrowers are graduating to other sources of credit because they are not financially capable and because non-FmHA lenders are reluctant to refinance them. Depressed agricultural market conditions have inhibited the financial improvement of such borrowers. This, when combined with various legislative, agency, and court actions, has resulted in FmHA's continuing to finance many of its farm program borrowers for extended periods. For example, about 42 percent of FmHA's 263,000 borrowers with active loans as of December 31, 1986, had continuously participated in FmHA farm loan programs for 7 years or longer.

FmHA borrowers have received significant benefits at a substantial cost to the government. For example, GAO estimated that during 1986 alone the government interest rate subsidies received by FmHA farm program borrowers—the difference between the interest rate charged the farmer and the interest cost the government incurred to obtain the funds it loaned—was between $612 million and $1.6 billion. FmHA borrowers also have a financial advantage over other farmers who must pay higher interest rates to borrow money from non-FmHA lenders. GAO estimated this advantage amounted to between $1.1 billion and $2.2 billion during 1986.

GAO's Analysis

Limited Graduation Potential

To potentially graduate from FmHA financing, borrowers must be financially successful so that they are attractive to a non-FmHA lender. Depressed agricultural market conditions have made this difficult and only 19 of 111 FmHA borrowers GAO reviewed in 8 FmHA county offices in 8 states—a limited, nonprojectable sample—appeared to be financially capable of graduation. When GAO questioned non-FmHA lenders about their willingness to refinance these 19 borrowers, none of the lenders expressed a strong interest in doing so. In general, the financial condition of these borrowers represented a higher risk than the non-FmHA lenders were willing to accept.

Weaknesses in Graduation Process

GAO found that 5 of the 8 FmHA county offices reviewed did not comply with all aspects of FmHA's graduation review process. GAO also found that FmHA does not clearly define or consistently interpret the term "graduation." For example, FmHA's existing graduation definition is unclear as to whether a borrower who pays off a loan by the sale of

assets is a graduate. In addition, some FmHA officials consider a graduation to occur only when all of a borrower's loans are refinanced with non-FmHA financing, while others consider the refinancing of any single loan to be a graduation. GAO also found that FmHA does not have reliable information on the results of its graduation efforts.

As a result, FmHA cannot properly monitor its graduation process because it does not know how many borrowers have graduated. FmHA officials believe, however, that few borrowers have graduated over the past several years. In the eight county offices GAO reviewed, only three graduations, based on GAO's interpretation of FmHA's current graduation definition, took place during 1985 and 1986. These 8 counties had approximately 1,975 borrowers in their farm loan portfolios.

Should borrowers' economic and financial conditions improve, FmHA must be in a position, through a well defined graduation process, to ensure that borrowers capable of obtaining non-FmHA financing are identified and graduated.

FmHA Has Evolved Into a Continuous Source of Credit

Many FmHA borrowers have remained in FmHA farm loan programs for extended periods. For example, about 42 percent of the total number of borrowers have remained continuously in such programs for 7 or more years. This includes about 57,600 borrowers who have stayed in FmHA farm programs continuously for 10 or more years.

Many factors over which FmHA has limited control have contributed to its evolvement into a continuous source of credit. One factor—a depressed agricultural market—is beyond both the borrowers' and FmHA's control. Another contributing factor is that neither the Congress nor FmHA has defined what is meant by the term "temporary source of credit" or how FmHA should fulfill this role. In addition, various legislative, agency, and court actions have required FmHA to continue to finance even its financially weakest borrowers.

FmHA Borrowers Receive Subsidized Credit and Other Financial Benefits

FmHA borrowers received credit that no other lender was willing to provide. These borrowers also benefit from significant government interest rate subsidies. In 1986, about 263,000 FmHA borrowers with about 770,000 outstanding loans received a government interest rate subsidy that GAO estimated was between a lower and upper bound of $612 million and $1.6 billion. In addition, by participating in FmHA farm loan programs, farmers also generally pay a lower interest rate than farmers

who must obtain credit from other lenders. GAO estimated that the financial advantage gained by FmHA borrowers over other farmers in 1986 was between $1.1 billion and $2.2 billion. The range in our estimates was caused by data limitations on such factors as the governments' actual cost for funds loaned to each borrower.

Recommendations

To properly manage its graduation process in anticipation that borrowers' economic and financial conditions will improve, GAO recommends that the Secretary of Agriculture direct the FmHA Administrator to (1) develop a precise operational definition of "graduation," (2) monitor county office compliance with graduation requirements, and (3) collect, summarize, and distribute accurate data on the results of the graduation process.

Matters for Congressional Consideration

FmHA's trend toward becoming a continuous source of credit raises fundamental questions regarding its mandate to be a temporary source of credit while, at the same time, fulfilling its role as a lender of last resort. The Congress may wish to reevaluate the current and future role of FmHA by examining several key issues, including the following.

- At what point will the cost of providing long-term credit assistance to financially marginal farmers—including the cost of loan losses, interest rate subsidies, and administrative expenses—outweigh the benefits to the government, rural communities, and the farmer?
- If FmHA is to serve as a temporary source of credit, should specific criteria—such as time limits and/or measurable financial improvement—be developed to decide when a borrower has had a sufficient opportunity to become financially sound and be in a position to graduate to non-FmHA sources of credit?
- For those borrowers who, after a period of time, show little or no prospect for succeeding, would it be more appropriate to provide other forms of assistance, such as job training, to aid in possible transition to other employment opportunities?

Agency Comments

USDA agreed with the findings of this report and said it appreciated the accurate manner in which the report presents the background and reasons for the current graduation situation. USDA also provided details on FmHA actions related to the recommendations of this report. These comments and our evaluation are discussed in chapter 2.

Contents

Executive Summary		2
Chapter 1 Introduction		8
	Financial Condition of FmHA's Farm Loan Portfolio	8
	Temporary Source of Subsidized Credit	9
	Graduation From FmHA Financing	10
	Keeping Farmers in Business	10
	Objectives, Scope, and Methodology	11
Chapter 2 FmHA Borrowers' Financial Condition Makes Graduation Difficult		16
	Limited Graduation Potential of FmHA Farm Borrowers	16
	Graduation Review Process Not Always Followed	20
	Lack of Consistent Graduation Definition and Reliable Graduation Data Hinders Implementation	22
	Conclusions	24
	Recommendations to the Secretary of Agriculture	25
	Agency Comments and Our Evaluation	25
Chapter 3 FmHA Has Evolved Into a Continuous Source of Subsidized Credit		26
	Borrowers Remain in FmHA's Farm Loan Programs for Long Time Periods	26
	FmHA Borrowers Receive Significant Financial Benefits	27
	Factors Contributing to FmHA's Evolvement to a Continuous Source of Credit	32
	Conclusions	37
Chapter 4 Observations and Matters for Consideration by the Congress		39
Appendixes		
	Appendix I: Request Letter From the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry	42
	Appendix II: Comments From the Under Secretary for Small Community and Rural Development, Department of Agriculture	43

Appendix III: FmHA County Offices Reviewed by GAO 45
Appendix IV: Major Contributors to This Report 46

Tables

Table 3.1: Number of Years of Involvement in FmHA's Farmer Programs and Volume of Loan Activity for All Active Borrowers as of December 31, 1986 27
Table 3.2: Estimated Interest Rate Subsidy Paid by Government to All FmHA Farm Borrowers in Calendar Year 1986 29
Table 3.3: Estimated Financial Advantage Received by All FmHA Farm Borrowers in Calendar Year 1986 30
Table 3.4: Estimated Government Interest Rate Subsidy and Financial Advantage Received by Three Selected Continuous Borrowers 31

Figure

Figure 1.1: FmHA Major Farm Program Outstanding Principal—Direct Loans, June 30, 1976-87 9

Abbreviations

FARMS	Farmer Program Management Information System
FmHA	Farmers Home Administration
GAO	General Accounting Office
RCED	Resources, Community, and Economic Development Division
USDA	U.S. Department of Agriculture

Introduction

The U.S. Department of Agriculture's Farmers Home Administration (FmHA), under the Consolidated Farm and Rural Development Act, as amended (P.L. 87-128, Aug. 8, 1961), is, among other things, to serve as a temporary source of credit for family farmers whose financial situation prevents their obtaining credit elsewhere at reasonable terms. As such, FmHA is commonly referred to as the "lender of last resort" for farmers. A major FmHA program objective, as mandated by the act, is to achieve refinancing of borrowers' loans by other sources of credit. In other words, FmHA is to "graduate" farmers with sufficiently improved financial conditions, as determined by the Secretary of Agriculture, to credit from non-FmHA lenders. The act also provides statutory authority for FmHA's farm loan programs.

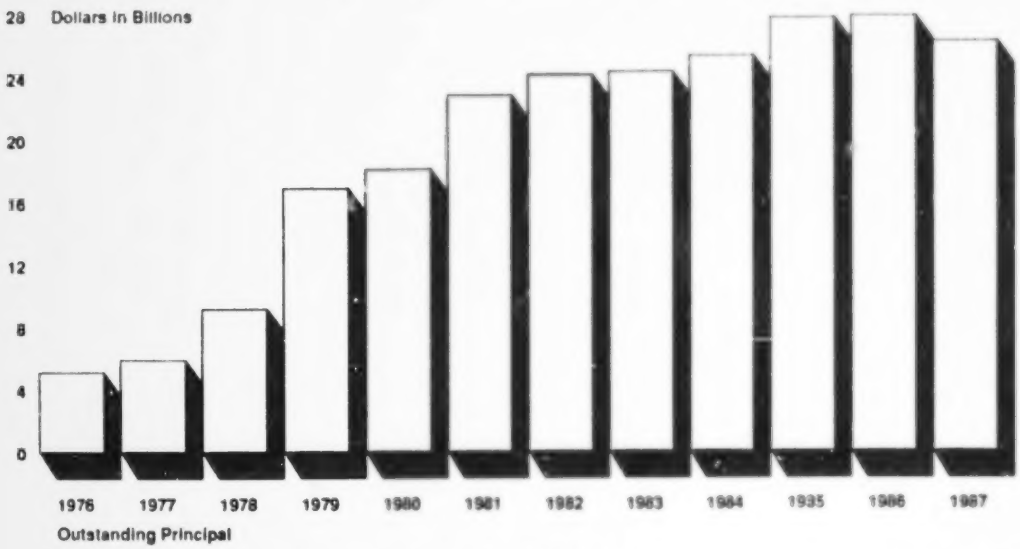
As of December 31, 1987, FmHA had provided financial assistance to about 14 percent of the nation's farmers through direct loans and guarantees on loans made by other lenders for purchasing, expanding, and operating farms. FmHA's major farm loan programs include

- farm ownership loans to buy and improve farm land and to construct, repair, and improve buildings,
- farm operating loans for feed, seed, fertilizer, livestock, farm and home equipment, living expenses, and seasonal hired labor,
- emergency loans for actual losses caused by natural disasters, and
- soil and water loans to help farmers and ranchers develop, conserve, and properly use land and water resources.

Financial Condition of FmHA's Farm Loan Portfolio

Farmers' financial condition deteriorated significantly between the mid-1970s and the mid-1980s. During that period, increasing numbers of farmers, who had been turned down for financing by private lenders, went to FmHA for credit assistance. FmHA responded and substantially increased its loan portfolio. For example, from June 30, 1976, to June 30, 1987, the outstanding principal in FmHA's major farm loan programs increased more than 400 percent, from about $5.1 billion to about $26.2 billion.

Figure 1.1: FmHA Major Farm Program Outstanding Principal—Direct Loans, June 30, 1976-87



Source: GAO analysis of FmHA Active Borrowers Delinquent Report data (FmHA report code 616)

As outstanding principal increased for FmHA's major farm programs, so did delinquent payments and the amount of unpaid principal owed by delinquent borrowers, decreasing their likelihood of graduating from the loan programs. Between June 30, 1976, and June 30, 1987, the amount of delinquent payments rose from about $464 million to about $7.0 billion, while total outstanding principal owed by delinquent borrowers grew from about $723 million to over $12.8 billion. Over this same 11-year period, the delinquent amount owed by severely delinquent borrowers, those over 3-years delinquent on one or more loans, increased from about $41 million to about $5.5 billion. This group's total outstanding principal on June 30, 1987, was about $6.7 billion.

Temporary Source of Subsidized Credit

The Congress intended for FmHA to provide farm loans to farmers who are unable to obtain non-FmHA financing because of their poor financial condition. FmHA's loans are typically below the prevailing interest rates charged creditworthy farmers by commercial lenders and usually even below the interest rates paid by the government on the money it borrows. FmHA loans are intended to be provided on a temporary basis.

FmHA borrowers are expected to refinance these loans with non-FmHA lenders when their financial condition improves.

Graduation From FmHA Financing

FmHA regulations state that FmHA loans are a temporary source of credit and that borrowers must graduate to non-FmHA credit as soon as practicable. The regulations define "graduation" as,

"The payment in full of an FmHA loan before maturity by refinancing through other credit sources. This definition does not include those borrowers indebted for only the current year's operating expenses or who sell out voluntarily or involuntarily and pay their loan(s) in full."

The regulations prescribe a detailed step-by-step graduation process, specifying tasks to be performed by FmHA county, district, and state officials. FmHA county supervisors are responsible for analyzing the financial viability of borrowers in their loan portfolios at least once every other year to identify those borrowers with potential for graduation. They are assisted in the graduation process by county committees comprised of local farmers.

The county supervisors are also responsible for meeting with lending officials from organizations such as Federal Land Banks, Farm Credit Services, savings and loan associations, banks and insurance companies in their areas and for maintaining a record of lenders' credit policies. County supervisors are required to actively attempt to match those borrowers with potential for graduation with appropriate lenders in the area. FmHA's district and state offices are responsible for monitoring the graduation process. However, graduations cannot occur without the willingness of non-FmHA lenders to refinance FmHA borrowers.

Keeping Farmers in Business

While legislation directs FmHA to be a temporary source of credit, it also tasks the agency to use loans and loan servicing as a means of helping farmers stay in business. FmHA provides extensive credit assistance to farmers when they initially obtain loans and afterwards as FmHA borrowers. Initially, farmers receive loans from FmHA because they are unable to obtain credit elsewhere. These loans generally have lower than commercial interest rates and generous repayment periods. Once borrowers obtain loans, further assistance may be provided through loan servicing, which is intended to facilitate loan repayment.

Additional credit may also be provided from FmHA or other credit sources with FmHA assistance. This aspect of its mission—keeping farmers in business—has been legislatively emphasized during the depressed agricultural market of the 1980s. For example, in July 1987 the Congress in making supplemental appropriations for fiscal year 1987 (P.L. 100-71, July 11, 1987) directed FmHA to reinstate the "continuation policy," which FmHA had rescinded in November 1985. This policy allows existing FmHA borrowers to obtain additional operating loans without demonstrating the ability to repay prior loans. In January 1988 the Congress also enacted the Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988), which directed FmHA to restructure delinquent debt rather than foreclose on the farmer if restructuring is less costly to the government. The act states that priority is to be put on writing down principal and interest, and on debt set-aside, whenever this would keep a borrower on the farm.

Objectives, Scope, and Methodology

In a December 22, 1986, letter, the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry requested that we review FmHA's farm loan graduation policies and procedures. Our objectives were to determine (1) if FmHA is graduating successful borrowers as legislatively mandated, (2) if FmHA has become a long-term source of credit for some borrowers, and (3) the amount of government subsidy and financial advantage provided all borrowers, including long-term borrowers.

We performed our review at FmHA headquarters, Finance Office, and eight selected county offices and their respective state and district offices. Our selection of FmHA state and county offices for review was based on geographic location, level of farm marketings, and borrower financial status. We used fiscal year 1986 cash receipts reported by the U.S. Department of Agriculture's Economic Research Service to determine the level of farm marketings by state. This process allowed us to avoid selecting states with minimal agricultural activity. As shown in appendix II, we selected states in various parts of the country to provide a national overview of agricultural and financial conditions. Using FmHA financial records, we determined borrowers' debt-to-asset ratios and loan repayment histories to ensure that the counties we selected for review had some borrowers with the potential to graduate.

Graduating Borrowers

To determine if FmHA graduated successful borrowers as legislatively mandated, we performed three tests. First, we determined whether the

eight selected county offices' graduation processes complied with applicable laws and implementing regulations that require an analysis of the financial viability of all borrowers in their portfolio. Using a checklist we developed, we reviewed the graduation process for the 1985 and 1986 review cycles in each selected county office on the basis of the loan graduation review procedures prescribed by FmHA's implementation regulation.

Second, by independently identifying FmHA borrowers with potential for graduation, we tested the adequacy of FmHA's graduation process. We evaluated financial data on 178 judgmentally selected borrowers (from a total of 1,975 borrowers) at the 8 county offices who appeared to have some potential to graduate and, where data were available, classified all 178 borrowers as to their potential to graduate. We identified potential FmHA graduates using the following criteria: (1) borrowers in FmHA's Master Borrower File who had repaid 35 percent or more of their original loan and (2) borrowers in FmHA's Farmer Program Management Information System (FARMS) having a debt-to-asset ratio of 40 percent or less. Our analysis of graduation potential was limited in some instances because county office files were incomplete or outdated. In such cases, we relied on testimonial evidence from county supervisors. The classification process we used was based on a modified version of an FmHA system used to classify borrower potential for financial success or failure. FmHA does not use this classification system, however, to determine whether or not borrowers should graduate to non-FmHA financing.

Third, we determined whether or not county office staffs were identifying non-FmHA financing for borrowers with potential for graduation by examining FmHA county office records for compliance with appropriate graduation review procedures. We also interviewed 38 judgmentally selected non-FmHA lenders to determine their interest in refinancing FmHA's borrowers. According to county staffs in the eight offices, these were the primary farm lenders in their respective locales.

Continuous Credit Source

To determine if FmHA has become a continuous source of credit for some borrowers, we used FmHA's Status Report of Farmer Program Accounts as of December 31, 1986, and stratified all borrowers by the number of years they had participated continuously in FmHA's farm loan programs. We also performed case studies of three judgmentally selected borrowers to illustrate both the length of time a borrower can be involved with FmHA credit programs and the extent of credit received.

Interest Rate Subsidy and Financial Advantage

For all borrowers with active loans on December 31, 1986, we estimated the government interest rate subsidy and financial advantage received during calendar year 1986. Secondly, we calculated the government interest rate subsidy and financial advantage received by three judgmentally selected borrowers, over the terms of their involvement, who had participated in FmHA's farm loan programs for 7 years or more and had received at least 10 loans. For both analyses we defined "government interest rate subsidy" as the difference between what an FmHA borrower had to pay the government in interest on FmHA program loans and the interest cost incurred by the government to obtain funds it loaned to the borrower. We defined "financial advantage" as the savings an FmHA borrower gains over other farmers who have to pay higher commercial rates for money they borrow. Our estimate of the financial advantage received by FmHA borrowers is conservative in that farmers who obtain an FmHA loan do not qualify for commercial credit and, if they did, would probably pay a higher interest rate than we estimated. It is important to note that the government interest rate subsidy and the financial advantage must be viewed separately and cannot be added together.

We were unable to precisely calculate the amount of government interest rate subsidy and financial advantage received by all FmHA borrowers because of data limitations. For example, the government's actual borrowing cost for funds loaned to each borrower in FmHA's farm portfolio was not known. In addition, the interest rate charged high-risk agricultural borrowers by commercial sources varies by lender and no historical aggregate data exist. Accordingly, we had to rely on other data sources to approximate the government's borrowing costs and commercial lending rates. We used the yield rate for 10-year Treasury securities to estimate the government's borrowing cost and the commercial bond rate with an investment rating of BAA to estimate commercial lending rates. The yield rate for 10-year Treasury securities was selected because FmHA repayment periods for actual borrowings vary between 5 and 20 years depending on the use of loan funds. The BAA bond rate is defined by Moody's Rating Service as the rate charged borrowers who the lender believes will make scheduled payments on time but may have some difficulty. We selected this rate to represent risky but creditworthy borrowers. In our opinion, these rates were the best approximations of actual rates we could obtain and FmHA concurred.

Another data limitation involved FmHA's Status Report of Farmer Program Accounts, which showed that as of December 31, 1986, FmHA's national portfolio of about 771,000 farm loans contained about 279,000 loans that were more than $100 delinquent. The report states how much

each borrower is delinquent; however, if a borrower makes a partial payment, it does not show how much of the payment goes toward principal reduction and how much toward interest repayment. As a result, the interest subsidy received by borrowers making partial payments could not be determined with complete accuracy.

Because of these data limitations, we computed lower and upper bound estimates of the interest rate subsidy and financial advantage received by FmHA borrowers. To illustrate, in computing the lower bound estimates, we assumed that all loans were repaid on time (both principal and interest)—i.e., none were delinquent. This assumption, in our opinion, would result in an understatement of subsidies and advantages because we know there were 279,000 delinquent loans as of December 31, 1986. In computing the upper bound estimates, we assumed that no payments were made during 1986 on any delinquent loan. This assumption, in our opinion, would produce an obvious overstatement of government interest rate subsidies and financial advantage because some delinquent borrowers had made partial payments.

Similarly, our precision in estimating the government interest rate subsidy and financial advantage received by three judgmentally selected borrowers was limited by incomplete data. Because payment histories for each borrower were not always available, we assumed that any reductions in loan principal were achieved through equal installment payments made on time. We considered reductions to be the difference between the original loan principal and the principal at December 31, 1986. We further assumed that all interest was paid by the borrowers except for debt set-aside loans. In such cases, payments of interest are deferred, so we used a zero percent interest rate in making our estimates.

FmHA's Assistant Administrator for Farmer Programs and the Director of FmHA's Budget Office reviewed our methodology. They stated that the methodology and assumptions used were valid for approximating the government interest rate subsidy and financial advantage received by FmHA borrowers.

As previously stated, our selection of FmHA sites, the 178 borrowers for review of the graduation process, and the 3 borrowers for illustrating the costs of providing long-term credit to FmHA borrowers was made in a subjective manner; and the results are not statistically projectable to the universe of FmHA sites or borrowers. However, our calculations of government interest rate subsidies and financial advantage do provide an

overall range of the estimated subsidy and advantage received by FmHA borrowers during 1986.

We conducted our review from March 1987 through April 1988, and our work was performed in accordance with generally accepted government auditing standards.

Chapter 2

FmHA Borrowers' Financial Condition Makes Graduation Difficult

FmHA has difficulty in graduating borrowers from its loan programs. Its borrowers are generally in a marginal financial condition, and non-FmHA lenders are reluctant to refinance them. Although FmHA has a graduation review process in place, some county offices we reviewed did not always comply with it. In addition, FmHA is unable to properly manage its graduation process because (1) the existing graduation definition is interpreted differently within the various FmHA management levels and does not address the full range of borrower repayment methods and (2) reliable information on actual borrower graduations is not available. As a result, FmHA has been unable to monitor the progress of its graduation program because it does not know how many graduations have or have not occurred. FmHA officials believe, however, that few graduations have taken place the past several years. Only through compliance with a review process that uses a consistent, clearly understood definition of graduation can FmHA ensure that potential graduates are identified and graduated as borrowers' economic conditions improve.

Limited Graduation Potential of FmHA Farm Borrowers

Borrowers must be financially successful to be attractive to a non-FmHA lender—a prerequisite to their graduation from FmHA financing. The financial records of borrowers we reviewed and our discussions with officials at the county offices and selected lending institutions showed that few FmHA borrowers were financially capable of graduation. In addition, non-FmHA lenders were reluctant to refinance those who appeared to be financially capable.

Few FmHA Borrowers Are Financially Capable of Graduation

The financial condition of the FmHA borrowers in the eight county offices we visited showed that few were financially capable of graduation. For example, only 19 of 111 cases we reviewed appeared capable of graduation. To identify borrowers with potential to graduate, we modified FmHA's method for classifying loans, which is based on the borrower's potential for financial success.

The 8 FmHA county offices in our review had loans outstanding to 1,975 borrowers. We judgmentally selected 178 of the borrowers and classified their graduation potential using a GAO-modified version of the FmHA Classification of Farmer Program Borrower Accounts. FmHA established this system to comply with the Office of Management and Budget's Circular A-129, which requires all federal agencies with loan programs to implement a loan classification system. The objectives of the system are to (1) assess the quality of the agency's loan portfolio, (2) estimate loan losses, (3) assess the need for special loan servicing, and (4) improve the

management of the loan programs. Although not using this system in its graduation review process, FmHA is classifying all borrowers in its portfolio as to their potential for financial success or failure.

FmHA's loan classification system is based on loan security margin and four key financial ratios: the debt-to-asset ratio, return on assets, current ratio (current assets divided by current debts), and repayment ability ratio (amount of cash available to make current debt payments divided by the total current debt and interest payments due). In analyzing borrowers, FmHA assigns a numerical value (key ratio point) to each ratio. On the basis of the sum of these key ratio points, and whether the FmHA security margin is positive or negative, each borrower is classified in one of five categories.

1. Commercial - borrowers represent FmHA's highest quality farmer accounts and should be requested to graduate to non-FmHA financing.

2. Standard - borrowers are acceptable to FmHA but could possibly obtain financing from other lenders.

3. Substandard - borrowers are experiencing financial difficulties and repayment ability is marginal.

4. Doubtful - borrowers have inadequate repayment ability and liquidation is likely.

5. Loss - borrower's financial condition has deteriorated to a point where repayment of loans cannot be anticipated.

For our analysis, we calculated the four ratios, but we did not calculate an amount for FmHA's security margin. The security margin calculation requires current market value of loan security, which was not available at county offices. This factor was not critical to our analysis because our purpose was to identify borrowers in good financial condition. As a result, we assumed that all borrowers we reviewed had a positive security margin. This made any borrowers who actually had a negative security margin appear financially better off than they actually were. However, only the categories of "doubtful" and "loss" involve a negative security margin. Thus our methodology resulted in all such borrowers being classified as at least "substandard."

We could classify only 111 of the 178 borrowers we selected because (1) 16 had recently paid off their loans or were not required to graduate

because of an administrative oversight in their loan agreements and (2) county office files lacked data needed to classify another 51. Of the 111 borrowers we classified

- 10 (9 percent) were commercial, indicating that they should be able to obtain non-FmHA financing,
- 38 (34 percent) were standard, indicating that they could possibly obtain non-FmHA financing, and
- 63 (57 percent) were substandard, indicating that they could not obtain non-FmHA financing.

Based on our classification system, 48 of the 111 borrowers could possibly graduate to non-FmHA financing. The financially based classification system, however, cannot be used as the sole criteria for graduation. According to county supervisors, other financial conditions, such as recent crop failures or market fluctuations, as well as nonfinancial factors, such as marital problems, divorce, poor health, and death in the family, preclude graduation in some cases. On the basis of our review of individual borrower files and discussions with county supervisors, such conditions inhibited graduation of 29 of the 48 borrowers we had classified as commercial or standard. Thus, only 19 of 111 borrowers we classified had reasonable graduation potential.

All FmHA state, district, and county officials we interviewed told us that depressed agricultural market conditions have had a profound effect on the financial condition of many farmers, especially those obtaining credit from FmHA. They said that rising production costs and falling commodity prices seriously inhibited financial improvement of such farmers.

FmHA officials further stated that depressed agricultural market conditions have been particularly burdensome to FmHA borrowers and have affected their potential capabilities to graduate to non-FmHA sources of credit. FmHA state officials in Florida and California said that the very condition that allows a farmer to participate in FmHA programs is the same one that makes those farmers more susceptible to failure—inability to obtain other financing.

Non-FmHA Lenders Reluctant to Refinance FmHA Borrowers

Our discussions with non-FmHA lenders about their willingness to refinance FmHA borrowers in general, and the 19 borrowers we identified as having graduation potential in particular, showed that they have little interest at best. We questioned 38 non-FmHA lenders about their level of

interest in refinancing FmHA borrowers as a general proposition. None of the lenders expressed a strong interest, 21 expressed a weak interest, and the remaining 17 lenders were not interested at all.

We also discussed with 18 of the 38 lenders their specific interest in refinancing the 19 borrowers that we believed had the best potential for graduation. These 18 lenders were located in the counties where the 19 borrowers had obtained credit from FmHA. We categorized their interest as either strong, moderate, weak, or rejected, using the following criteria, which we had developed:

Strong - Lender exhibited a high degree of interest in refinancing with few, if any, qualifications and may take the initiative to contact the county supervisor.

Moderate - Lender exhibited interest in refinancing with only limited qualifications.

Weak - Lender exhibited limited interest in refinancing and had significant qualifications.

Rejected - Lender expressed an unwillingness to consider refinancing the borrower.

Although in some cases the lenders showed weak to moderate interest, none of them expressed strong interest in refinancing the borrowers. In general, the poor financial condition of these borrowers represented a higher risk than the non-FmHA lenders were willing to accept.

FmHA officials were aware of non-FmHA lenders' reluctance to refinance their borrowers. A majority of the FmHA state, district, and county officials we interviewed (18 of 24) stated that in their opinion non-FmHA lenders were reluctant to refinance potential FmHA graduates because of their relatively poor financial condition. Conversely, one state director, one district director, and two county supervisors said that in their opinion FmHA borrowers with potential to graduate could obtain non-FmHA financing as easily as other agricultural borrowers. Two district directors did not express opinions on the potential for non-FmHA financing for FmHA borrowers.

Graduation Review Process Not Always Followed

FmHA has developed requirements that county offices are required to follow in identifying borrowers with potential to graduate. However, the county offices we reviewed did not always comply with them. Although the existing economic environment made the adverse effects of noncompliance negligible in our opinion, FmHA's graduation review process should be improved and complied with as borrowers' financial conditions improve.

Graduation Review Requirements

The graduation review process begins on October 1 each year with the arrival of a Borrower Graduation Review list,[1] prepared by FmHA's Finance Office. Using this list, county supervisors are to perform an initial screening to eliminate from further consideration those borrowers who are clearly unable to graduate. County supervisors are required to briefly document their decision on the list next to each borrower's name.

Next, a thorough review is to be conducted for borrowers not eliminated during initial screening. A county committee is to assist county supervisors in performing this review, which is designed to eliminate borrowers who are unable to meet non-FmHA lending requirements such as borrower income, assets, and repayment history. If information in a borrower's file is insufficient to evaluate graduation potential, county supervisors send borrowers a letter requesting additional or current financial information.

Borrowers not eliminated from graduation consideration during the thorough review phase should be listed on FmHA's Results of Borrower Graduation Review report. These borrowers are to be requested by letter to graduate to alternative non-FmHA credit. Borrowers who fail to respond to the first letter are to be sent a follow-up letter, which specifies a time frame for response before FmHA begins legal proceedings. If borrowers do not respond to instructions within specified time frames, county supervisors should forward their files to state directors for concurrence to take legal action to collect repayment of their loans.

If a borrower is successful in graduating, the date the loan is paid off is to be recorded on the Results of Borrower Graduation Review report. If unable to graduate, borrowers must provide written evidence. If, after considering this additional information, county supervisors and county

[1] The Borrower Graduation Review List prepared in even numbered years includes those borrowers whose initial loans were made in even numbered years. The same procedure applies to borrowers whose loans were made during odd numbered years.

committees decide to withdraw the request to graduate, then the date of and reason for withdrawal is to be recorded on the Results of Borrower Graduation Review report.

County Supervisors Did Not Consistently Comply With Graduation Review Procedures

We evaluated compliance with the required graduation review process during the 1985 and 1986 review cycles for all borrowers in the eight county offices included in our review. We found that five of the eight county offices did not always carry out specific graduation process requirements. In addition, in other instances we were unable to verify if the correct action had been taken because relevant documents had been misplaced or discarded and were unavailable for our review. We were able to confirm that a combined total of only three borrowers had been graduated, based on our interpretation of FmHA's current graduation definition, as a result of the graduation efforts of the eight counties during the 1985 and 1986 review cycles. During this period, these 8 counties had about 1,975 borrowers in their farm loan portfolios.

We noted that five of the eight county offices did not comply with the graduation process requirements. For example, two county supervisors (in Tennessee and Iowa) did not conduct an initial screening of borrowers in 1985, nor did an Oklahoma supervisor in 1986. No subsequent graduation review steps were performed at any of these three locations. The county supervisors in Iowa and Oklahoma stated that performing required review steps was futile because they already knew that none of their farm borrowers could graduate. In Tennessee, the impact of skipping the required review in 1985 also appeared negligible, in our opinion. All three county supervisors said the poor farm economy inhibited the chances for financial improvement of their borrowers.

Three county supervisors (in Ohio, Tennessee, and Indiana) did not document the decisions resulting from initial screening of borrowers for potential graduation. Two (in Indiana and Tennessee) did not record reasons for withdrawal of a graduation request as required.

Lack of Consistent Graduation Definition and Reliable Graduation Data Hinders Implementation

Two elements integral to identifying borrowers with potential to graduate are lacking. First, the various units we reviewed within FmHA do not have a commonly accepted definition or concept of "graduation." Second, FmHA does not have reliable information on the number of borrowers it does, or does not, graduate. Because of these problems FmHA does not know how many graduations may have occurred in the past. FmHA officials believe, however, that few graduations took place over the past several years.

"Graduation" Not Clearly Defined or Consistently Interpreted

FmHA officials in headquarters, state, district, and county offices provided us various opinions on what constitutes a borrower graduation. The existing "graduation" definition is interpreted differently within various FmHA management levels. This resulted in some counties' inconsistently counting the number of borrowers they had graduated. In addition, graduation as currently defined by FmHA regulations does not address the full range of loan repayment methods used by borrowers.

To illustrate, some headquarters officials considered FmHA borrowers to have graduated only when they refinanced all of their FmHA loans to non-FmHA financing. Others, however, considered borrowers to have graduated each time they refinanced any of their loans. Under the second definition, a borrower could graduate one FmHA loan to non-FmHA financing while at the same time have several other outstanding FmHA loans. FmHA headquarters officials also disagree on whether or not a graduation occurs when a borrower pays off a direct FmHA loan with a guaranteed FmHA loan. Finally, the headquarters officials we interviewed did not agree on whether loans paid off with funds from unknown sources, inheritance, or sale of assets, such as equipment and farm property, constituted a graduation.

Similar disparate interpretations existed among FmHA officials within a state. In Tennessee, for example, the chief of farmer programs said that in order for a farmer to be considered a graduate, the borrower must have been identified through the graduation review process. However, an FmHA county supervisor in Tennessee said that he would count refinancing as a graduation regardless of whether or not the borrower had been identified through the graduation review process. The district director told us he did not know how to define graduation.

According to FmHA implementation regulations, a graduation occurs when a borrower pays off an FmHA loan by refinancing it with a

non-FmHA lender. The 8 county offices we visited told us they had graduated a combined total of 22 borrowers from fiscal year 1985 to the dates of our visits. (This is a different time period than the 2-year graduation review cycle previously discussed.) During this period the combined loan portfolios of these counties included approximately 2,000 borrowers. We reviewed 12 of these graduations at 3 county offices. FmHA county offices had purged their records on the other 10 cases. In our opinion, 4 of the 12 were clear-cut cases of graduation based on our interpretation of FmHA's current graduation definition. Three of the remaining eight did not meet the definition of graduation because the farmers had quit farming, sold or rented their farms, and paid off their FmHA loans. In the other five cases, we did not have sufficient information to determine if the borrowers had graduated because the county offices failed to determine the source of the funds used to pay off the loans and did not know if the borrowers had sold their farms.

Reliable Information on FmHA Graduations Not Available

According to FmHA officials, including the Assistant Administrator for Farmer Programs, FmHA does not have reliable information on the number of borrowers it has graduated. These officials believe, however, that few graduations have occurred over the past several years. As mentioned earlier, our examination of the 8 county offices' 1985 and 1986 graduation review cycles tended to support this belief—we could confirm only 3 graduations from a total borrower population of 1,975.

Two FmHA reports—FmHA's 813 Report and its County Office Operating Report—include the number of graduations, but officials from FmHA's Statistics and Reports Branch described both as unreliable. The 813 Report, titled "Number of Borrowers Whose Debts Have Been Refinanced Through Other Credit Sources," includes as graduations aggregate data on borrowers who have left FmHA through (1) refinancing loans with non-FmHA lenders, (2) bankruptcy, (3) debt settlement, (4) voluntary conveyance, and (5) other means. It is possible according to FmHA's Chief, Statistics and Reports Branch, that some of those borrowers counted in the 813 Report did not remain active in farming. Another complication with this report is that it is set up by loan type; therefore borrowers with multiple loans would be counted more than once. Consequently, the report is unsuitable for tracking borrowers who graduated from FmHA to non-FmHA financing.

The County Office Operating Report is a consolidation of reports submitted by FmHA county offices. FmHA requests its county office personnel to report how many borrowers were reviewed for graduation, how many

were requested to graduate, and how many actually did graduate. According to FmHA Statistics and Reports Branch officials, the county office reports are unedited, often incomplete, and subject to varying interpretations by county office personnel as to what constitutes a borrower graduation.

FmHA's regulations require (1) state directors to monitor the orderly and timely review of FmHA borrowers for graduation and (2) district directors to monitor the county office graduation process for effectiveness and conformance. However, reliable data on borrower graduation activities are not collected. Only one of the eight state offices we visited had any data on graduations. Without reliable information FmHA cannot properly manage and monitor implementation of the graduation process.

Conclusions

The marginal financial position of FmHA's borrowers, reluctance of non-FmHA lenders to refinance them, and the overall poor farm economy have made graduation of FmHA borrowers extremely difficult. These problems are not controlled by or generally correctable by FmHA. Nevertheless, FmHA should comply with its graduation review process to ensure that potential graduates are identified and graduated as borrowers' financial conditions improve.

Further, to properly manage and monitor implementation of the graduation process, FmHA should, as a minimum, have (1) a clear, universally understood and accepted definition of what constitutes a graduation and (2) a reliable system for tracking and reporting results of the graduation process. While the concept of graduation is defined in both legislation and FmHA regulations, FmHA officials in headquarters, state, district, and county offices hold various opinions on what constitutes a borrower graduation. This has been caused by FmHA's not developing and communicating a precise operational definition of "graduation," including the uniform application of such a definition. As a result, FmHA does not know how many graduations have occurred.

Recommendations to the Secretary of Agriculture

To help ensure that FmHA borrowers with potential for graduation to non-FmHA financing are identified and graduated when their economic conditions permit, we recommend that the Secretary of Agriculture direct the FmHA Administrator to

- develop and convey to all FmHA units a precise operational definition of "graduation" and emphasize the importance of uniform application of that definition,
- monitor county office compliance with graduation requirements, and
- collect and summarize accurate data on results of the borrower graduation process and distribute such results to all appropriate management levels so that FmHA is kept informed of the progress made in graduating borrowers to non-FmHA sources of credit.

Agency Comments and Our Evaluation

In commenting on a draft of this report, the U.S. Department of Agriculture (USDA) agreed with our findings and said it appreciated the accurate manner in which the report presents the background and reasons for the current graduation situation. USDA also agreed that different views on the definition of "graduation" exist, but noted that FmHA regulations, in its opinion, contain an operational definition of "graduation." USDA also stated that it would continue efforts to ensure consistency in the interpretation of graduation. As discussed in this report, the definition to which USDA refers does not address the full range of loan repayment methods used by borrowers and has been subject to various interpretations by FmHA officials at all levels. Accordingly, we believe a need exists to develop and convey a more precise definition of "graduation" that is fully understood by all FmHA officials.

USDA also stated that FmHA currently monitors state and county office implementation of the graduation process as part of its Coordinated Assessment Review requirements. We concur with this statement; however, as shown in this report, implementation of the graduation process has been inadequate and, in our opinion, demonstrates the need for further county office monitoring to assure compliance with graduation requirements.

Finally, USDA stated that as of April 1988, the national and state offices of FmHA have had access to field office reporting on graduation. However, our report shows that this FmHA reporting system contains unreliable data that we believe need to be improved if FmHA management is to be accurately informed of the progress made in graduating borrowers to non-FmHA sources of credit.

FmHA Has Evolved Into a Continuous Source of Subsidized Credit

Congress established FmHA to, among other things, serve as a temporary source of credit, but FmHA has evolved into a continuous source of credit for nearly one-half of its borrowers. These farmers have received millions of dollars in government interest rate subsidies—the difference between the interest rate charged the farmer and the interest cost incurred by the government to obtain the funds it loaned the farmer. Farmers with FmHA loans also have a financial advantage over other farmers who must pay higher commercial rates for money they borrowed.

To some extent this situation is due to factors beyond the borrowers' and FmHA's control—such as a depressed agricultural market over the past few years. However, the Congress and FmHA have not defined the term "temporary source of credit" or how FmHA should fulfill its temporary credit provider role. In addition, a number of actions the Congress, FmHA, and the courts have taken to help alleviate the financial pressures on FmHA borrowers have further contributed to the situation. We did not determine to what extent farmers are responsible for their own financial difficulties.

Borrowers Remain in FmHA's Farm Loan Programs for Long Time Periods

At December 31, 1986, nearly 112,000 borrowers, or more than 42 percent of all FmHA farm borrowers, had had at least 1 active loan continuously for 7 years or more. This includes about 57,600 borrowers who have continuously remained in FmHA farm programs for 10 years or more. (See table 3.1). The 112,000 borrowers had about 371,000 active loans, totaling about $15 billion, with about $11.7 billion remaining outstanding as of December 31, 1986.

Table 3.1: Number of Years of Involvement in FmHA's Farmer Programs and Volume of Loan Activity for All Active Borrowers as of December 31, 1986

Dollars in Thousands

Years in FmHA	Number of borrowers	Percent of total	Number of loans received	Percent of total	Original loan amount	Percent of total	Current outstanding principal	Percent of total
0 to 3	94,684	35.9	262,524	34.1	$11,889,084	36.3	$10,637,098	39.4
3 to 5	30,267	11.5	70,011	9.1	3,057,732	9.3	2,535,935	9.4
5 to 7	25,951	9.9	65,784	8.5	2,824,387	8.6	2,160,386	8.0
Total under 7	**150,902**	**57.3**	**398,319**	**51.7**	**$17,771,203**	**54.2**	**$15,333,419**	**56.8**
7 to 10	54,303	20.6	185,323	24.0	$9,490,044	29.0	$7,394,403	27.4
10+ over	57,638	21.9	185,601	24.1	5,506,066	16.8	4,280,420	15.8
Total over 7	**111,941**	**42.5**	**370,924**	**48.1**	**$14,996,110**	**45.8**	**$11,674,823**	**43.2**
Not determined	625	2	1,465	2	10,133	0.0	3,232	0.0
Total	**263,468**	**100.0**	**770,708**	**100.0**	**$32,777,446**	**100.0**	**$27,011,474**	**100.0**

[a]We excluded from our calculations loans with a closing date prior to 1954 and those where data were not available. We did not have government or commercial interest rates for 1954 and before.

FmHA Borrowers Receive Significant Financial Benefits

When FmHA makes a loan it extends credit to a farmer whom no other lender is willing to finance at reasonable rates and terms. In addition to this benefit, an FmHA farm loan also provides many borrowers with two other measurable financial benefits. First, an FmHA loan can provide a borrower, at a cost to the government, with an interest rate subsidy. Second, an FmHA borrower usually has a financial advantage over other farmers who must pay higher interest rates on loans from non-FmHA lenders. Although it is important to note that the government interest rate subsidy and the financial advantage gained must be viewed separately and cannot be added, we estimated that both these values ranged in the hundreds of millions of dollars. To illustrate, we calculated the potential range of both the government interest rate subsidy received and financial advantage gained for all FmHA borrowers in calendar year 1986. We further estimated how much of the subsidy and advantage had been received by FmHA borrowers who continuously participated in FmHA farm programs for 7 years or more to demonstrate the potential impact of FmHA borrowers not graduating to non-FmHA sources of credit. By developing case histories on three borrowers, we also estimated how much subsidy and advantage had been received by individual borrowers during the term of their involvement with FmHA.

As discussed in chapter 1, data limitations would not allow us to make an exact determination of the interest rate subsidy and advantage

received. However, we could calculate lower and upper bound case scenarios to show a range of the estimated subsidies and advantage received during 1986. We believe, and FmHA officials concurred, the actual results lie somewhere between the low and high estimates.

Government Interest Rate Subsidies to FmHA Borrowers

The estimated cost (in terms of interest rate subsidies) to the government for providing loans to all FmHA farm program borrowers in calendar year 1986 was between $0.6 billion and $1.6 billion. Borrowers who continuously participated in FmHA farm loan programs for 7 or more years received estimated government interest rate subsidies between about $228 million and about $873 million. (See table 3.2.)

For this analysis, we computed the interest on each loan using FmHA's actual interest rate for individual loans and used the yield rate for 10-year Treasury securities as the cost of money to FmHA. We then estimated the government interest rate subsidy to FmHA borrowers by computing the difference in actual interest cost for FmHA loans and Treasury securities. The FmHA interest represents revenue collected by the government, and the interest on Treasury securities represents cost to the government. Therefore, the extent that the government's cost of Treasury securities exceed the government revenue from FmHA loan repayments represents an interest subsidy cost incurred by the government. For example, if the government paid $600 interest on a $10,000 Treasury security and collected $500 interest from a $10,000 FmHA loan, we described the $100 difference as a subsidy received by an FmHA borrower.

Table 3.2: Estimated Interest Rate Subsidy Paid by Government to All FmHA Farm Borrowers in Calendar Year 1986

Dollars in Thousands

	Assuming all borrowers paid all interest		Assuming delinquent borrowers paid no interest	
Years in FmHA	Estimated amount paid	Percent of estimated amount	Estimated amount paid	Percent of estimated amount
0 to 3	$246,723	40.3	$372,753	22.7
3 to 5	75,734	12.4	183,577	11.2
5 to 7	61,459	10.0	212,034	12.9
Total under 7	**$383,916**	**62.7**	**$768,364**	**46.8**
7 to 10	141,509	23.1	618,167	37.7
10+ over	86,913	14.2	254,496	15.5
Total over 7	**$228,422**	**37.3**	**$872,663**	**53.2**
Total	**$612,338**	**100.0**	**$1,641,027**	**100.0**

Financial Advantage to FmHA Borrowers

Farmers who receive an FmHA loan generally pay a lower interest rate than farmers who must obtain credit from non-FmHA lenders. We quantified this benefit and estimated that the financial advantage gained by all FmHA borrowers over other farmers in 1986 was between about $1.2 billion and about $2.2 billion. The financial advantage received by FmHA borrowers who continuously participated in FmHA farm loan programs for 7 years or more lay between about $441 million and about $1.1 billion in 1986. (See table 3.3.)

We estimated the financial advantage to FmHA borrowers by computing the difference in interest cost for FmHA loans using FmHA's actual loan rate and the commercial bond rate with an investment rating of BAA—the cost of money to high-risk farmers borrowing from commercial sources. The FmHA interest represents cost to farmers who borrowed from FmHA and the bond rate represents cost to farmers who borrowed from commercial sources. Therefore, the extent to which the cost of loans was less for FmHA borrowers represents a financial advantage over non-FmHA borrowers. For example, a borrower who pays $500 interest on a $10,000 FmHA loan receives a $300 financial advantage over another borrower who pays $800 interest on a $10,000 commercial loan.

Table 3.3: Estimated Financial Advantage Received by All FmHA Farm Borrowers in Calendar Year 1986

Dollars in Thousands

	Assuming all borrowers paid all interest		Assuming delinquent borrowers paid no interest	
Years in FmHA	**Estimated advantage**	**Percent of advantage**	**Estimated advantage**	**Percent of advantage**
0 to 3	$497,420	42.1	$623,450	28.2
3 to 5	132,014	11.2	239,857	10.8
5 to 7	111,670	9.4	262,245	11.9
Total under 7	**$741,104**	**62.7**	**$1,125,552**	**50.9**
7 to 10	272,244	23.0	748,902	33.9
10+ over	168,496	14.3	336,079	15.2
Total over 7	**$440,740**	**37.3**	**$1,084,981**	**49.1**
Total	**$1,181,844**	**100.0**	**$2,210,533**	**100.0**

Case Studies of Three FmHA Borrowers

Individual borrowers can receive thousands of dollars in government interest rate subsidies and have a financial advantage over non-FmHA borrowers. We performed case studies of three borrowers and estimated the extent of the interest rate subsidies and financial advantage they received over the term of their involvement with FmHA. These case studies are not representative of all FmHA borrowers but were selected to illustrate the amount of interest rate subsidy and financial advantage some borrowers obtain when receiving many loans over a long period of participation in FmHA farm programs. These three borrowers had been in FmHA farm programs for a combined total of 58 years—an average of about 19 years per borrower. During that time they received a total of 118 loans—an average of 39 per borrower.

Because county offices had purged information on many of the old loans, we were able to reconstruct loan histories on only 92 of the 118 loans to the 3 borrowers. These 92 loans totaled about $1.6 million—an average of about $528,000 per borrower. The estimated government interest rate subsidy totaled about $141,000—an average of about $47,000 per borrower. The three borrowers received an estimated $289,000 in financial advantage over non-FmHA borrowers—an average of about $96,000 per borrower. The government interest rate subsidy and financial advantage estimates are expressed in constant 1986 dollars. (See table 3.4.)

Table 3.4: Estimated Government Interest Rate Subsidy and Financial Advantage Received by Three Selected Continuous Borrowers

Borrowers	Years in program	Total loans received	Reconstructed loans		Government subsidy[a]	Financial advantage[a]
			Number	Amount		
A South Carolina	28	50	27	$484,490	$25,400	$62,867
B Indiana	15	29	27	597,145	66,983	127,932
C Iowa	15	39	38	501,357	49,053	98,141
Total	**58**	**118**	**92**	**$1,582,992**	**$141,436**	**$288,940**
Average	19.3	39.3	30.7	$527,664	$47,145	$96,313

[a]Expressed in constant 1986 dollars.

Despite the three borrowers' continuous participation in FmHA farm loan programs and the resulting government interest rate subsidies and financial advantages, FmHA county supervisors concluded, as late as 1986, that these borrowers were unable to graduate to non-FmHA financing. The loan history of each borrower illustrates this situation.

Borrower A

A cotton and soybean farmer in South Carolina had participated in FmHA farm loan programs continuously for over 28 years. During that time he received 50 loans, 27 of which we were able to reconstruct. Those 27 loans totaled $484,490. As of December 31, 1986, the estimated cumulative government interest rate subsidy and financial advantage received on the 27 loans totaled $25,400 and $62,867, respectively, expressed in constant 1986 dollars. His net worth as reported on February 3, 1987, was $1,005 less than on April 17, 1958, when he first applied for FmHA credit. He continues to farm and, as of December 31, 1986, had five loans with an outstanding principal of $50,704. In February 1987 he received his 51st loan from FmHA, for $21,000. Notwithstanding the benefits received over his 28-year participation in FmHA's loan programs, this borrower is still unable to qualify for non-FmHA credit.

Borrower B

A hog, corn, and soybean farmer in Indiana had participated in FmHA farm loan programs for over 15 years and received 29 loans. We were able to reconstruct loan histories for 27 of the 29 loans. Those 27 loans ranged in amounts from $1,816 to $111,731 and totaled $597,145. As of December 31, 1986, six loans were outstanding with a principal balance of $326,792. By December 31, 1986, we estimated the borrower had received cumulative government interest rate subsidies of $66,983 and financial advantages of $127,932 over other farm borrowers financed

by non-FmHA lenders. Both calculations are expressed in constant 1986 dollars. Despite the interest subsidies and financial advantages received, the borrower reported a 51-percent decline in his net worth from 1971 to 1986. In 1985 his difficulty in repaying existing FmHA loans qualified him to participate in FmHA's debt set-aside program. This, in addition to his serious decline in net worth, indicated his continued inability to graduate to private financing.

Borrower C

After 15 years in FmHA's farm loan programs, an Iowa farmer, raising corn, soybeans, and cattle, had received 39 loans. He had 14 loans with a balance of $435,790 outstanding as of December 31, 1986. For 38 loans on which we could develop reliable histories from FmHA files, FmHA had taken 17 loan-servicing actions, including rescheduling, reamortization, and debt set-aside. The 38 loans ranged from $2,500 to $90,524 and totaled $501,357. We estimated in constant 1986 dollars that the borrower had received $49,053 in government interest rate subsidies and $98,141 in financial advantage over non-FmHA farm borrowers. Despite FmHA assistance, the borrower's reported net worth declined from $20,368 in 1971 to a negative $6,635 in 1986. The borrower was unable to graduate at that time given his weak financial position.

Factors Contributing to FmHA's Evolvement to a Continuous Source of Credit

FmHA's evolvement to a continuous source of credit is due to some extent to factors beyond both the borrowers' and the government's control. For example, when market conditions in the agricultural economy decline, as they did in the early 1980s, many farmers encounter financial difficulties and turn to FmHA for credit. Such conditions also make it very difficult for existing FmHA borrowers to improve enough financially to qualify for credit from non-FmHA sources. However, several other factors have contributed to this situation. Specifically, factors that the Congress and FmHA can control have been used to keep financially stressed farmers in business. For instance,

- Neither the Congress nor FmHA has defined what is meant by the term "temporary source of credit."
- The continuation policy has allowed delinquent borrowers, many of whom are severely delinquent, to obtain new operating loans without showing the ability to repay all outstanding debt.
- FmHA has taken extensive loan-servicing actions, such as the rescheduling and reamortization of loans and the restructuring of debt, which have allowed delinquent borrowers to stay in business.

- Court decisions have severely restricted FmHA's ability to take foreclosure steps against delinquent borrowers.

"Temporary Source of Credit" Not Defined

Authorizing legislation and implementing regulations governing FmHA's farm loan programs mandate that the agency is to be a temporary source of credit and that borrowers graduate when they are able to do so. Although FmHA's original authorizing legislation provided for specific time limits for repaying loans, these limits have been lengthened by subsequent legislative changes. In addition, subsequent agency, court, and congressional actions have required FmHA to continue to finance even its financially weakest borrowers.

The extension of loan repayment terms does not change FmHA's legislative mandate to graduate borrowers, nor does it affect a borrower's ability to graduate. However, such action does lengthen the amount of time borrowers can stay in FmHA farm programs before their loans are due and thus effectively extend FmHA's involvement with the borrowers.

The Farmers Home Administration Act of 1946 (P.L. 731) established the maximum term for farm ownership loans at 40 years, and required that terms for production and subsistence loans (the forerunner of operating loans) "not exceed 5 years from the date the original loan was made—including renewals and extensions." In 1951 an amendment to the Bankhead Jones Farm Tenant Act (P.L. 123) lengthened the term of operating loans to 7 years. In 1956, Public Law 878 allowed an additional 3 years for repayment, if the Secretary found that the borrower's inability to repay the debt within the 7-year limit was due to causes beyond the borrower's control. The Consolidated Farm and Rural Development Act of 1961 (P.L. 87-128) further lengthened this discretionary extension period to 5 years, increasing the possible loan term to 12 years. In 1984, Public Law 98-258 amended this act and provided the Secretary with authority to consolidate or reschedule outstanding operating loans for payment over a period not to exceed 15 years.

FmHA officials provided several reasons for the gradual modifications of loan terms from an absolute maximum of 5 years to include longer initial loan terms and the possibility of extensions. According to the Chief of FmHA's Direct Loan and Property Management Branch, the requirement that FmHA keep borrowers for only 5 years was modified because the arbitrary 5-year cutoff was viewed as being unfair to borrowers who were making progress but were still unable to graduate. He added that because farming itself is risky, difficult to gauge, and unique in each

region, arbitrary deadlines on loan repayment were not considered practical.

In addition to legislative actions, FmHA loan-servicing regulations in place since 1979, as discussed in the next two sections, effectively allowed borrowers to stay in the same farm loan programs far longer than was originally intended. For example, terms for operating loans now usually range from 1 to 7 years, according to loan purpose, with a maximum repayment period of 15 years. However, loan repayment can be extended indefinitely for many delinquent borrowers by using continuation policy loans and loan-servicing options, such as consolidation, rescheduling, and deferral of loan payments.

"Continuation Policy" Allowed Delinquent Borrowers to Remain in Business

As agricultural economic conditions worsened in the early 1980s, FmHA found itself with loan requests from farmers who had limited loan repayment ability. In an effort to assist farmers who were dealing with difficult farm credit conditions, FmHA, in February 1982, revised its loan-servicing policy to allow borrowers to obtain additional (new) financing without showing the ability to repay prior loans. This policy, which became known as the continuation policy, stated that FmHA would continue to work with present borrowers who, among other things, had a reasonable chance to repay only a new loan. Payments to be made on existing debt were deferred. This policy allowed FmHA to avoid liquidating many delinquent borrowers, but it also resulted in extending their length of time in the portfolio. Although FmHA did not keep records on the number of continuation loans made, Farmer Program officials estimated that about 12,000 borrowers received continuation loans during the period 1982 through 1985.

In our January 1986 report entitled, Farmers Home Administration: Financial and General Characteristics of Farmer Loan Program Borrowers (GAO RCED-86-62BR, Jan. 2, 1986), we estimated that during the first 6 months of 1985, FmHA loaned over $2 billion to about 19,000 borrowers that had either extreme financial problems (debt-to-asset ratio of 70 percent to 99 percent) or were technically insolvent (debt-to-asset ratio of 100 percent or more). Although records were not kept, FmHA believes that many of these borrowers received continuation loans.

In November 1985 FmHA issued a directive that terminated the continuation policy. It was replaced with a new loan-servicing policy that required borrowers to be current on all loan payments before additional

credit would be provided. The Assistant Administrator for Farmer Programs stated that FmHA made this change because of the deteriorating financial condition of the farm loan portfolio and mounting loan losses, which exceeded $335 million in 1985 alone. However, in the supplemental appropriations act for fiscal year 1987 (P.L. 100-71, July 11, 1987), the Congress approved a provision that reinstated the continuation policy. While there is no way of knowing who will apply for continuation loans in the future, FmHA has estimated that about 12,000 delinquent farmers are eligible and could stay in the portfolio by obtaining operating funds under the continuation policy in 1988.

Extensive New Servicing Options Keep Some Borrowers in Business

When FmHA recognizes that a borrower will be unable to make a scheduled loan payment, it can use loan-servicing options to make the account current. These options typically involve reducing interest rates and/or extending loan repayment periods. While servicing may bring borrowers' loans current on scheduled payments, they also can extend the length of time a farmer continues to be an FmHA borrower.

FmHA initiates foreclosure only after all other loan-servicing options have been exhausted. This policy attempts to help delinquent borrowers make their accounts current and allow them to remain in the loan program. FmHA may allow the borrower to restructure the debt and farm operation by selling a portion of the assets or may subordinate its lien position to another lender to allow the borrower to get additional non-FmHA credit. FmHA also reschedules or reamortizes loans to enable delinquent borrowers to have a positive cash flow. By offering maximum terms, for example extending the number of years over which the loan may be repaid, FmHA assists its borrowers. Additionally, FmHA may change the interest rate of the loan to a lower, "limited resource" rate or defer a portion of the principal or interest.

Another FmHA option is to consolidate the loan by combining and rewriting similar loans made for operating purposes at new rates and terms. From October 1, 1981, through September 30, 1987, FmHA estimates that it rescheduled, reamortized, or consolidated loans for approximately 268,500 borrowers. In a March 1987 hearing before the Senate Committee on Agriculture, Nutrition, and Forestry, FmHA testified that in fiscal year 1986 it was able to keep 98 percent of its farm borrowers in business because of loan-servicing actions. During fiscal year 1987 alone, FmHA estimates that it rescheduled, consolidated, or reamortized loans for about 31,800 borrowers, deferred principal or interest for 1,250 borrowers, and subordinated its lien position for about 29,500 borrowers.

With the January 1988 enactment of the Agricultural Credit Act of 1987, the Congress took further steps to keep borrowers who cannot repay FmHA farm loans in business. As discussed in chapter 1, the act directs FmHA to give priority consideration to reducing loan principal and interest of delinquent borrowers' debt when all other loan-servicing options are not sufficient to allow the borrower to show debt repayment ability. The loan restructuring provisions provide that FmHA must first write-down (reduce) delinquent debt to the recovery value of the collateral if the return to the government is at least as great as the return the government would receive if it foreclosed and liquidated the borrower's assets. Although implementing regulations have not been finalized, FmHA has estimated that approximately 16,200 of its farm borrowers will be eligible for the loan write-down, with about $2.1 billion of debt being written off as a loss. In addition, loan losses from other borrowers who will be unable to show repayment of debt even after write-down are estimated at about $6.7 billion. As a result, FmHA estimates total potential losses to be about $8.7 billion by fiscal year 1990.

Lawsuits Have Kept Many Borrowers in FmHA Programs

During the 1980s FmHA borrowers filed various lawsuits that challenged, among other things, the legality of the agency's foreclosure process. Court decisions in these suits temporarily prevented FmHA from initiating foreclosure actions. As a result, many of FmHA's most delinquent borrowers have remained in its farm programs for extended periods.

Court cases filed between November 1981 and May 1983 challenged, among other things, FmHA's implementation of certain foreclosure actions against delinquent borrowers and resulted in court-imposed delays in the foreclosure process. Coleman v. Block, initiated by several North Dakota farmers in May 1983 as a national class action lawsuit, resulted in injunctions suspending a number of FmHA foreclosure actions until the agency provided certain notices and explanations of other procedures to borrowers. To conform to the order of the Federal District Court of North Dakota, on November 1, 1985, FmHA issued revised regulations (50 Fed. Reg. 45739) establishing procedures for the systematic servicing of delinquent borrower accounts, which is required for foreclosure action. However, during the approximately 3-year period before FmHA issued the revised regulations, FmHA loan foreclosures decreased from 844 in 1982 to 89 in 1985.

Again in June 1987, the same North Dakota federal district court in Coleman v. Lyng, 663 F. Supp. 1315, 1339 (D.N.D. 1987), enjoined FmHA from instituting foreclosure action on delinquent borrowers. The judge

declared FmHA's intent-to-take adverse action notices void because they did not fully describe a farmer's legal rights in the loan-servicing and foreclosure process. Adverse action notices are sent to delinquent borrowers to notify them that their loans are in trouble and that they need to contact FmHA to try to develop a workable repayment plan. As a result of the ruling, FmHA has suspended all foreclosure action against its delinquent borrowers since July 1987. The suspension was still in effect in October 1988.

On November 5, 1987, FmHA appealed the court order after its revision of the intent-to-take adverse action letter was declared not to correct its faults. However, the Agricultural Credit Act of 1987 may make moot several of the issues contained in the appeal because the act prohibits FmHA from initiating any foreclosure action on any farm program loan before the date the Secretary of Agriculture issues final regulations to carry out the debt restructuring and loan-servicing options of the new law. The implementing regulations were due to be issued the summer of 1988. On September 14, 1988, FmHA published in the Federal Register an interim rule, with a 60-day comment period, to implement the act's provisions.

Conclusions

Over the years, FmHA has evolved into a continuous source of subsidized credit for nearly one-half of its borrowers. As shown in chapter 2, FmHA has had difficulty graduating its financially strongest borrowers to private credit due in part to a depressed agricultural market, which has hindered the ability of borrowers to improve financially. At the same time, in an effort to keep financially stressed farmers in business, various legislative actions have required FmHA to continue to finance its financially weakest borrowers. In addition, several court decisions in the 1980s on the legality of FmHA's foreclosure process have temporarily prevented FmHA from initiating foreclosure actions on many of FmHA's most delinquent borrowers.

FmHA borrowers have received significant benefits. In providing credit to these borrowers, the government and ultimately the taxpayers incur extensive costs. We estimated that in 1986 these costs, as measured in terms of government interest rate subsidies to FmHA farm borrowers, were between $0.6 billion and $1.6 billion. Furthermore, FmHA borrowers enjoy a financial advantage over other farmers who must rely on commercial sources of credit, which we estimated was between $1.2 billion and $2.2 billion in 1986.

In chapter 4, we provide some observations and issues for the Congress' consideration on the issues of graduation and FmHA's role as a temporary source of credit.

Observations and Matters for Consideration by the Congress

FmHA was established to serve, among other things, as a temporary source of credit for family farmers whose financial situation prevented their obtaining credit elsewhere at reasonable terms. In addition, FmHA has operated under a mandate to graduate, if possible, borrowers from its farm loan programs. As shown in chapters 2 and 3, over the past several decades, this role and mandate have been deemphasized in favor of a policy of keeping farmers in business for long periods regardless of their financial condition. This has been accomplished in a variety of ways that involved all three branches of the government. For example, the Congress approved a continuation policy to keep farmers in business with new loans even if they cannot show an ability to repay all outstanding debts. FmHA provides continuous servicing of loans to keep farmers in business. And the courts, through various orders and injunctions, have temporarily suspended FmHA foreclosure actions until FmHA clarifies certain notices and procedures for its borrowers.

While this policy has been successful in keeping farmers in business, it has not been without cost. Interest rate subsidies to farmers have risen to the hundreds of millions of dollars and FmHA's farm loan portfolio and delinquencies have increased dramatically, placing the federal government and, ultimately the taxpayers, at considerable risk. A previous GAO report[1] noted that over 10 fiscal years (1978 through 1987), annual loan losses in FmHA's major farm programs (net of proceeds from sales of loan collateral) grew from about $41 million in 1978 to over $1.1 billion in 1987 for direct loans. In addition, the administrative expenses of the Agriculture Credit Insurance Fund (a revolving fund used to finance FmHA farm loans) are significant costs—about $159 million in fiscal year 1986 and about $165 million in fiscal year 1987.

We recognize that the Congress, through its recently passed legislation, wants to continue to assist financially stressed farmers and keep them in business if at all possible. However, FmHA's trend toward becoming a continuous source of credit raises fundamental questions regarding its mandate to serve as a temporary source of credit while, at the same time, fulfilling its role as a lender of last resort. Because of the substantial costs involved, the Congress may wish to reevaluate the current and future role of FmHA by examining several key issues, including the following:

[1] Farmers Home Administration: Farm Program Debt, Delinquencies, and Loan Losses As of June 30, 1987 (GAO/RCED-88-134BR, May 20, 1988).

- At what point will the cost of providing continuous credit assistance to financially marginal farmers—including the cost of loan losses, interest rate subsidies, and administrative expenses—outweigh the benefits to the government, rural communities, and the farmer?
- If FmHA is to serve as a temporary source of credit, should specific criteria be developed—such as time limits and/or measurable financial improvement—to decide when a borrower has had a sufficient opportunity to become financially sound and be in a position to graduate to non-FmHA sources of credit?
- For those borrowers who, after a period of time, show little or no prospect for succeeding, would it be more appropriate to provide other forms of assistance, such as job training, to aid in possible transition to other employment opportunities?

In the final analysis, such decisions will require congressional judgments about complex, and sometimes competing, objectives—such as the need to maintain a strong, productive farm capacity, maintain the economic viability of rural communities, and hold federal outlays down at a time of scarce federal resources.

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Request Letter From the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry

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United States Senate

COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON, DC 20510

December 22, 1986

The Honorable Charles Bowsher
Comptroller General of the United States
General Accounting Office
Washington, D. C. 20548

Dear Mr. Bowsher:

The Farmers Home Administration provides subsidized farm credit to farmers who cannot obtain private financing at reasonable rates and terms. One legislatively mandated condition of this credit is that FmHA is to be a temporary source of credit and that borrowers must graduate to private lenders when they are able to do so.

Clearly, Congress does not intend to provide FmHA borrowers with a long term financial advantage over farmers who do not receive subsidized credit nor does it intend for FmHA to compete with private sources of farm credit. Therefore, more attention needs to be given to the graduation of more FmHA borrowers who are financially able to do so. Since fiscal year 1983, FmHA estimates that less than 1 percent of its total farm borrowers have refinanced their debt through other credit sources.

This Committee believes that in an era of scarce federal resources, FmHA must manage its programs efficiently and assure that subsidized credit is provided only to those farmers who need it. Toward this end, I am requesting that the General Accounting Office review FmHA's farm loan graduation policies and procedures. I believe that such an assessment will result in improved targeting of limited FmHA resources and services. We will be glad to discuss this issue with your staff at any time.

With kindest regards.

Sincerely,

Jesse Helms

JESSE HELMS
Chairman

Comments From the Under Secretary for Small Community and Rural Development, Department of Agriculture

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

SEP 1 3 1988

Mr. J. Dexter Peach
Assistant Comptroller General
Resources, Community, and Economic
Development Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

A review has been made on the proposed GAO report dated, August 31, 1988, Entitled, "Farmers Home Administration: Farm Loan Programs Have Become a Continuous Source of Subsidized Credit".

We agree with the findings of the report and appreciate the accurate manner in which the report presents the background and reasons for the current graduation situation.

To properly manage its graduation process in anticipation that borrowers' economic and financial conditions will improve, GAO recommends that the Secretary of Agriculture direct the FmHA Administrator to (1) develop an operational definition of graduation, (2) monitor County Office compliance with graduation requirements and (3) collect, summarize, and distribute accurate data on the results of graduation process.

(1) We agree that there may be different views on the definition of graduation. However, Subpart F of Part 1951 - Analyzing Credit Needs and Graduation of Borrowers contains the following operational definition:

> "Graduation - The payment-in-full of an FmHA loan before maturity by refinancing through other credit sources. This definition does not include those borrowers indebted for only the current year's operating expenses or who sell out voluntarily or involuntarily and pay their loan(s) in full."

We will continue efforts to ensure consistency in the interpretation of "graduation".

(2) A review of the graduation process at the State and County level is part of Coordinated Assessment Reviews requirements.

(3) As of April 1988, State Offices can access the Field Office Operating Reports Systems (FOORS) for graduation data as submitted by each of their County Offices on the monthly County Office Operating Report (COOR), FmHA Form 2006-11. Also, the National Office produces a National recap report, for both Farmer Programs and Housing of the graduation data available in (FOORS) (see attached sample report.)

Sincerely,

FmHA County Offices Reviewed by GAO

State	County Offices
1 California	• Modesto
2 Florida	• Bonifay
3 Indiana	• Greensburg
4 Iowa	• Osceola
5 Ohio	• Greenville
6 Oklahoma	• Chickasha
7 South Carolina	• Dillon
8 Tennesee	• Covington

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